

## **BUDGET 2004**

### **COMMENT: SEVEN UP WITHOUT THE FIZZ**

We have been quite critical of budgetary policy in recent years, reflecting in particular, the fact that fiscal policy has been excessively pro-cyclical. Spending was allowed to grow too rapidly in the boom times while taxes were hiked sharply and capital spending was cut in the last two years at a time of weak economic growth.

On top of this, the taxpayer has been left to pick up very costly bills in relation to some government decisions, most notably in relation to the benchmarking pay awards for public servants and the Special Savings Scheme, the merits of which are dubious. Today's budget is an improvement on recent years. It is a relatively neutral budget in terms of the economy.

The Minister emphasised that today's budget adopts a strategic outlook aimed at ensuring Ireland is well placed to reap the benefits of the international upturn that is currently getting underway. In this regard, the increases in indirect taxes are more modest than in the 2003 budget. Thus, inflation should decline to a 2.2 - 2.5% range in 2004, helping competitiveness.

Growth in current expenditure is in line with the expected nominal growth rate of the economy. Thus, the government has re-established more control over current spending after the runaway growth rates of earlier in the decade. A new approach on public investment was announced in today's budget. This involves a greater focus on the medium term via dedicated five year 'financial envelopes' in areas such as road building, a welcome development.

Our main criticism is that the Minister had scope to do more for the economy in today's budget, but chose not to, especially in the area of capital spending and income tax. The Irish public finances are in exceptionally good order. Our debt/GDP ratio at 33% is very low, while the projected 2004 General Government budget deficit of €1.6bn, or 1.1% of GDP, is quite small and well within the confines of the EU Stability and Growth Pact. We would favour a higher budget deficit to finance additional capital spending and more generous income tax cuts.

Two years ago, in its medium term budgetary outlook, the government forecast that Exchequer financed voted capital spending would rise to €6631m in 2004 from €5,441m in 2002. The 2004 budget, though, provides for a figure of just €5,566m, a cutback of over €1bn on the original estimate, or 16%. Scaling back on badly needed infrastructural spending makes no sense, especially when the public finances are in such a healthy state. It depresses economic activity and, in the longer term, will curtail the potential growth rate of the economy.

Instead, it would be preferable if the government had targeted a higher deficit to finance capital projects that provide a clear economic or social return. Hopefully, today's announcement of five year 'financial envelopes' for capital expenditure will mean that, in future, such spending is ring fenced from the capriciousness of the annual Estimates round, where it has often been the easy target in the past.

Meanwhile, for the second year in a row, the Minister has been very parsimonious on income tax, announcing just a €240 rise in the employee tax credit to €1,040. There was no change again, this year in the personal tax credit. The standard rate tax band was also left unchanged again pushing many more workers on to the top rate tax. We call this bracket creep. Granted the Minister's room for manoeuvre is limited by the costs of benchmarking and SSIs. However, it would have helped to fuel the domestic economic recovery if the Minister had been more generous on income tax. Today was this Minister's seventh budget. It strikes us as a rather flat affair, 7-Up without the fizz.

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## BUDGET 2004: KEY FEATURES

### 2004 BUDGET TARGETS

- \* **Exchequer Deficit** of €2,806m (2.4% of GNP) in 2004, compared with government expectations for a 2003 deficit of €1,510m (1.4% of GNP).
- \* **General Government Deficit** of €1,635m (1.1% of GDP) in 2004 against an expected 2003 outturn of a €594m (0.4% of GDP).
- \* The Exchequer Deficit is projected to measure 1.7% and 1.4% of GNP in 2005 and 2006, with the General Government deficit estimated at a respective 1.4% and 1.1% of GDP in each of these years.
- \* The General Government Debt as a percentage of GDP is projected to be marginally higher at 33.3% in 2004 from 33.1% in 2003. This is expected to rise to 33.5% in 2005 before falling back to 33.3% in 2006.

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### EXPENDITURE MEASURES

- \* Budget day Social Welfare measures totalling €608m in 2004 and €630m in a full year.
- \* Old age pensions increased by €10 per week, bringing the Old Age Contributory Pension to €167.30 per week, effective from January 2004.
- \* Child Benefit increased by €6 for first and second children to €131.60 per month; and by €8 per month for each of the third and subsequent children to €165.30 per month, effective from April 2004.
- \* Extra €30m allocated for school buildings in 2004.
- \* Gross Non-Capital supply services expenditure figure for 2004 at €35.5 billion, up 7.4% on the 2003 level.
- \* Gross voted capital expenditure is projected to rise to €5,566m in 2004, an increase of 2.5% on the 2003 level.

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### TAXATION MEASURES

#### *Income Tax*

- \* No change in basic tax credits or tax bands for the second year running.
- \* Employee PAYE tax credit increased by €240 to €1,040. This will remove 39,200 taxpayers from the tax net.
- \* Income tax exemption limits for those aged 65 or over increased by €500 to €15,500 for a single person and by €1,000 to €31,000 for a married couple.

#### *PRSI*

- \* Employee PRSI ceiling raised from €40,420 to €42,160, an increase of 4.3%

#### *VAT and Excise Duties*

- \* Cigarette duty increased by 25c per packet of 20.
- \* Duty on petrol and diesel increased by 5c per litre.

- \* No change in duty on spirits or other alcohols.
- \* Excise duty changes to add 0.4% to the CPI rate in 2004.

### ***Business Taxation***

- \* Business Expansion Scheme (BES) extended for a three year period to 31 December 2006.
- \* The BES company limit to be increased from its current level of €750,000 to €1million.
- \* The tax relief for investment in films scheme to be extended for another 4 years to 31 December 2008.
- \* Tax relief on construction projects underway extended to July 2006.

### ***Capital Gains Tax***

- \* No changes in capital gains taxes.

### ***Other Measures***

- \* Significant decentralisation of government departments and agencies, which will involve the relocation of eight departments incorporating 10,300 civil and public service jobs.
- \* Specified rate for preferential loans to be cut to 3.5% from 4.5% in respect of home loans, with effect from 1 January 2004.
- \* No changes in property stamp duty rates.
- \* No changes in stamp duties on cheques, credit/charge cards and ATM/laser cards.
- \* Reform of Public Service Pensions scheme including removal of compulsory retirement age of 65.
- \* Special Savings Incentive Accounts left unchanged.

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## **CORPORATE IMPACT**

- \* The budget is broadly pro-business. The focus on minimising the rise in inflation in 2004 will contribute to improving competitiveness. However, the small scale of the personal tax reliefs will disappoint employees.
- \* The retention of the various schemes such as BES (until end 2006), film relief (until end 2008) and various construction related projects (until July 2006) provide positive sectoral supports.
- \* The Minister also introduced a tax credit for R&D where up to 20% can be offset against corporation tax
- \* The rise in fuel costs will be a blow to the transport sector
- \* The medium term commitment to maintain the general government deficit at below 1.5% of GDP will be welcomed. However, even more needs to be done on the capital side in order to reduce our infrastructural deficit. The Budget envisages that a growing proportion of public investment will be undertaken by the private sector under PPP's.

## BUDGET ASSESSMENT

### **EBR Projected To Rise To €2.8bn In 2004**

The table below sets out the principal features of the 2004 budget arithmetic. Central Fund expenditure is forecast to rise sharply. This reflects higher debt interest payments in the absence of drawdowns from the NTMA's Capital Services Redemption Account, which have helped to partly finance interest payments in recent years.

Net supply service spending is forecast to rise by 7.5% next year. The Minister announced increases in social welfare spending in the budget costing over €600m. Despite the efforts of the Minister to control growth in public spending, the public sector pay bill continues to rise at an alarming rate. The public sector pay bill has risen by 47%, or 14% per annum on average, over the past three years. It is forecast to rise by a further 9% in 2004, partly due to the payment of benchmarking pay awards.

Turning to the other side of the balance sheet, non-tax revenue is forecast to fall by €233m in 2004, reflecting a marked decline in the surplus income of the Central Bank. Meanwhile, the tax changes announced in the budget broadly cancel each other out. Tax receipts are forecast to rise by 5.2% in 2004.

On the current budget side, then, the surplus is projected to fall to €3bn from €4bn in 2003. On the capital side, voted expenditure is forecast to rise by 2.5%. Capital receipts are expected to decline by €85m next year. As a result, the capital borrowing requirement is projected to rise to €5.8bn from €5.5bn in 2003.

Overall then, the government predicts an Exchequer Borrowing Requirement of €2.8bn in 2004, up from €1.5bn in 2003. The Minister is targeting a General Government deficit of over €1.1bn next year, or 1.1% of GDP. This compares to a €0.6bn deficit in 2003 (0.4% of GDP).

How realistic are the Minister's budgetary targets? On the current spending side, there are certain to be pressures on services, especially health, and thus demands for more resources. Every year, though, sees an undershoot of interest payments in the Central Fund. Interest savings are likely again next year, which should help offset overruns on current supply service spending.

On the capital expenditure side, there is no reason why the spending projections should not be met. Capital receipts should also be close to target unless some unexpected privatisation monies accrue. Hence, capital borrowing should be close to target. As usual, then, the main uncertainty in relation to the budget outturn relates to tax revenues. Thus, it is worth looking at the government's 2004 tax projections in some detail.

BUDGET 2004				WHITE PAPER TAX REVENUE PROJECTIONS			
(€ Million)	2003 Projected Outturn	2004 Budget Target	% Change	€ million	2003 Projected Outturn	2004 Opening Position	Change %
<b>Current Spending</b>	<b>28,831</b>	<b>31,230</b>	<b>8.3</b>	Excise Duties	4,584	4,600	0.3
<i>of which</i>				VAT	9,611	10,244	6.6
(i) Central Fund	3,304	3,794	14.8	Income Tax	9,199	10,300	12.0
(ii) Supply Services	25,527	27,436	7.5	Corporation Tax	5,015	5,350	6.7
<b>Current Revenue</b>	<b>32,806</b>	<b>34,219</b>	<b>4.3</b>	Capital Taxes	1,559	1,000	-36.0
<i>of which</i>				Stamp Duties	1,646	1,600	-2.8
(i) Tax	31,754	33,400	5.2	Other	140	142	1.4
(ii) Non-Tax	1,052	819	-22.1	<b>Total</b>	<b>31,754</b>	<b>33,236</b>	<b>4.7%</b>
<b>Current Budget Surplus</b>	<b>3,975</b>	<b>2,989</b>					
<b>Capital Borrowing</b>	<b>5,485</b>	<b>5,795</b>					
<b>Exchequer Borrowing</b>	<b>1,510</b>	<b>2,806</b>					
(% of GNP)	(1.4)	(2.4)					
<b>General Government Deficit</b>	<b>594</b>	<b>1,635</b>					
(% of GDP)	(0.4)	(1.1)					

### ***Modest Rise Forecast By Dept In Tax Revenues***

Having exceeded target by large amounts during the later half of the 1990s, tax revenues undershot target significantly in two of the last three years. Not surprisingly, then, the Dept of Finance has forecast a modest rise of 4.7% in tax receipts in the 2004 White Paper. This seems rather low given that economic growth is likely to be of the order of 6% in nominal terms in 2004. It is worth analysing the forecasts in the 2004 White Paper for each of the main tax headings, given the different factors influencing the various tax categories. These forecasts are set out in the table on the previous page.

We feel that there are downside risks to the projections for excise duties and income tax receipts. By our estimates underlying excise duties fell by 4% this year, reflecting declining sales of alcohol, tobacco and cars. Given the introduction of the smoking ban in pubs from early 2004, a further decline in alcohol and tobacco sales seems likely next year. Car sales are difficult to predict but if they fall also, excise duties are unlikely to reach target in 2004.

Meanwhile, income tax receipts have been very weak for the past number of years, consistently undershooting budget target. Thus, it is difficult to understand why the Dept has forecast an increase of 12% in income tax receipts for 2004, especially after a rise of just 1.5% in 2003. Personal income is unlikely to rise by more than 7 or 8% next year. Furthermore, we note that of the €1.5bn projected rise in the total tax take in the 2004 White Paper, €1.1bn comes from higher income tax receipts. This seems rather lopsided. In our view, income tax receipts could undershoot target by up to €400m.

### ***Budget Targets Look Realistic***

On the other hand, capital taxes which surged in 2003 are forecast to decline sharply in 2004. However, capital taxes will continue to benefit from accelerated payments in early 2004 as well as the curtailment of certain reliefs. Meanwhile, stamp duties should benefit from higher house prices on average in 2004 and the recovering stock market. Thus, the take from stamp duties may not decline in 2004 as forecast by the Dept.

On corporation taxes, receipts are forecast to rise by 6.7% in 2004. However, changes in previous budgets will boost the yield from corporation taxes by some €200m next year. We estimate the underlying forecast rise for corporation tax in 2004 at 2.7% which seems low given the recovery in corporate profitability. Overall, we feel that the yield from capital taxes, stamp duties and corporate taxes could exceed target by several hundred millions, offsetting most of the likely undershoot in income tax and excise duties. Meanwhile, the forecast for VAT receipts looks reasonable enough.

Thus, while at a macro level, the Dept's forecasts appear cautious enough, taxes should finish the year close to target. With overall spending likely to finish the year close to target also, we feel the government should come close to meeting its budget deficits targets in 2004 for the third year in a row.

Indeed, judging by the end-November Exchequer returns, published yesterday, the budget deficit in 2003 could be a good deal lower than predicted in the White Paper. Tax receipts are likely to be higher than expected in 2003 while spending is running way behind target. A lower than expected budget deficit in 2003 should make the 2004 budget target easier to achieve, unless of course, a considerable amount of 2003 spending is pushed into 2004.

### ***A Neutral Budget***

The following table examines what the Minister has done on the current budget side today compared with his last four budgets. The opening current budget surplus of €3.2bn in 2004 is well down on the levels for 2000-2002, but close to the 2003 figure. The rise in spending of €400bn announced today is smaller than in previous budgets. The income tax concessions will cost €239m in 2004, while the Minister will take in €243m in higher indirect taxes. Thus, unlike in the last two years, this is not a tax raising budget, although the income tax giveaways are cancelled out by hikes in indirect taxes. Reflecting the cautious nature of this year's budget, the Minister has reduced his opening current budget surplus by just €238m.

The increases in social welfare payments and reductions in income taxes will cost some €850m in 2004. This will boost household disposable income by 1.1%. In real terms, (after allowing for the impact of the indirect tax increase of 0.4% on the CPI), the budget will boost disposable income by 0.7%. This suggests that today's budget is not that stimulatory.

ANALYSIS OF BUDGET DAY CHANGES (CURRENT) 2000-2004					
(€ million)	2000	2001	2002	2003	2004
Opening Balance (1)	+6,530	+9,655	+5,947	+3,401	+3,227
Closing Balance	+5,787	+7,676	+5,570	+3,685	+2,989
<b>Net Change in Balance</b>	<b>-743</b>	<b>-1,929</b>	<b>-377</b>	<b>+284</b>	<b>-238</b>
Spending Increases (2)	493	1,290	1,625	887	402
Tax Changes (3)	-602	-1,643	+710	+944	-17
Buoyancy Effect	+352	+1,004	+538	+227	+181
Net Change in Tax Revenue (4)	-250	-639	+1,248	+1,171	+164

1. The opening current budget balance takes account of departmental balances, pre-budget revisions to the Estimates and any adjustments to the Central Fund or non-tax revenue

2. Spending increases include those social welfare improvements met from the Social Insurance Fund

3. Includes changes in PRSI and Health levies.

4. Tax changes net of buoyancy effects.

Following today's budget, gross current voted government expenditure is set to rise by 7.5%, the same as in 2003. On the capital side, voted expenditure rises by 2.5%. Overall, total voted government spending is predicted to rise by 6.7% in 2004, close to the expected nominal growth rate of the economy. Combined with just modest tax cuts, it points to a relatively neutral budget.

The General Government balance (GGB) is a better measure than the Exchequer balance in assessing the overall stance of fiscal policy. The General Government deficit is forecast to rise to 1.1% of GDP in 2004 from 0.4% at GDP in 2003. In cyclically adjusted terms though, the Dept estimates that the deficit will fall to 0.5% of GDP in 2004 from 0.8% in 2003, suggesting a broadly neutral budget, but one that could have a slight tightening bias.

### Modest Income Boost For Taxpayers

The table below shows that taxpayers will benefit moderately from the budget, reflecting an increase in the employee tax credit and higher child benefit payments. Middle income earners in the €20,000 - €50,000 range fair best. Overall, the budget will boost the take home pay of a single person earning €30,000 by 1%. Families with two earners and children will benefit more, reflecting the increase in the employee tax credit and child benefit.

BUDGETARY CHANGES TO INCOME TAX/PRSI/CHILD BENEFIT IMPACT ON TAXPAYERS (1)								
Income €	Single Person		Married Couple (2)			Married Couple (3)		
	Total Gained €	Gain as % of Net Income	Total Gained €	Of which Child Benefit	Gain % of Net Income	Total Gained €	Of which Child Benefit	Gain % of Net Income
20,000	240	1.4	108	108	0.5	108	108	0.5
30,000	240	1.0	588	108	1.9	348	108	1.2
50,000	175	0.5	588	108	1.3	283	108	0.7
80,000	175	0.3	529	108	0.8	283	108	0.4
120,000	175	0.2	470	108	0.6	283	108	0.3

1. Full rate PRSI contributors. 2. Married Couple, two earners, two children. 3. Married couple, one earner, two children.

## THE BUDGET OUTLOOK TO 2006

### **Public Finances To Remain In Deficit**

The multi-annual budget projections for the public finances out to 2006, given in this year's budget are set out in the table below. In order to get a realistic view of the emerging budgetary situation, the costs of likely tax cuts and expenditure increases in the next two budgets are taken into account. A contingency provision is also included in 2005 and 2006 to allow for unseen factors that could impact on the public finances.

In its budgetary projections, the government is forecasting that the Exchequer deficit will increase to €3,432m in 2005, and €3,280m in 2006. It is projected that there will also be an increase in the General Government deficit to €2,127m in 2005 (1.4% of GDP) and €1,845m in 2006 (1.1% of GDP). These budgetary projections are based on forecasts of real GDP growth of 3% in 2004 and 4.7% in 2005, and 5.2% in 2006. Apart from the impact of the contingency provision already alluded to, the rising deficit reflects a sharp fall in the current budget surplus in 2004, along with increased capital borrowing.

The deterioration in the current budget position in 2004 partly reflects a decline in non-tax revenue and a big jump in Central Fund expenditure. Tax revenue is projected to rise at a slower pace than nominal GDP in 2004, but should be broadly in line thereafter. Spending, meanwhile, is forecast to rise in line with GDP in 2004 but at a somewhat dubious slower pace thereafter. Hence, the current budget surplus is projected to rise in 2005 and 2006. On the capital side, expenditure growth is also projected to be at a less robust pace than nominal GDP. Meanwhile, capital resources are projected to fall. Overall, it results in a steady rise in capital borrowing over the next three years. Overall, these figures point to a relatively benign outlook for the public finances, with continuing low budget deficits.

MULTI-ANNUAL BUDGET PROJECTIONS 2003 - 2006							
	2003 Estimated Outturn €m	2004 Budget €m	% Chg	2005 Projection €m	% Chg	2006 Projection €m	% Chg
<b>Current Budget</b>							
<i>Expenditure</i>							
(i) Central Fund	3,304	3,794	14.8	4,088	7.7	4,391	7.4
(ii) Supply Services	25,527	27,436	7.5	29,141	6.2	30,585	5.0
Total Expenditure	28,831	31,230	8.3	33,229	6.4	34,976	5.3
<i>Revenue</i>							
(i) Taxation	31,754	33,400	5.2	35,870	7.4	38,800	8.2
(ii) Non-Tax	1,052	819	-22.1	650	-20.6	667	2.6
Total Revenue	32,806	34,219	4.3	36,520	6.7	39,467	8.1
Current Budget Surplus (% of GNP)	3,975 3.6	2,989 2.5	-24.8	3,290 2.6	10.1	4,491 3.3	36.5
<b>Capital Budget</b>							
Capital Expenditure	6,823	7,049	3.2	7,263	3.0	7,545	3.9
Capital Resources	1,339	1,254	-6.3	1,164	-7.2	1,117	-4.0
Capital Borrowing (% of GNP)	5,485 -5.0	-5,795 -4.9	5.7	-6,099 -4.8	5.2	-6,428 -4.8	5.4
Contingency Provision	-	-		624		1,344	
<b>Exchequer Balance</b> (% of GNP)	<b>-1,510</b> -1.4	<b>-2,806</b> -2.4		<b>-3,432</b> -1.7		<b>-3,280</b> -1.4	
<b>General Government</b>							
<b>Balance</b> (% of GDP)	<b>-594</b> -0.4%	<b>-1,635</b> -1.1%		<b>-2,127</b> -1.4%		<b>-1,845</b> -1.1%	



## MACRO ECONOMIC FORECASTS AND EXCHEQUER FUNDING

### ***Growth To Pick Up And Inflation To Fall In 2004***

Most commentators, including ourselves and the ESRI, estimate that GDP grew by around 2% this year. Virtually all commentators agree that activity will pick up pace next year, helped by the recovery in the global economy, continuing low interest rates and a less restrictive fiscal stance than in 2003. The main fly in the ointment for 2004 is the strength of the euro, which is likely to have some dampening effect on exports.

Turning to the forecasts for 2004, we are more optimistic than the ESRI and Dept of Finance in forecasting GDP and GNP growth rates of 4.0% and 3.7% respectively for next year. The ESRI and Dept of Finance forecast GDP growth rates of just above 3%. AIB has been encouraged by the recent marked strengthening of leading indicators of Irish industrial activity and the strong upturn in the world economy. Thus, we have higher forecasts for exports and investment in 2004 than the ESRI or Dept of Finance.

Overall, though, all three forecasts see a pick-up in economic growth next year. All forecasters also agree, however, that growth will remain below trend in 2004, which will see unemployment rise further next year. The unemployment rate is seen averaging close to 5% in 2004 compared to 4.6% in 2003, as growth in public sector employment tapers off and jobs growth in the private sector remains sluggish.

The Dept of Finance estimates that the indirect tax increases in the budget will boost the CPI by 0.4% in 2004. This gives an average rate of 2.5% for next year, down from 3.5% in 2003. The ESRI has forecast that inflation will average around 2.6% next year. Our forecast is for inflation to average 2.2% in 2004. Thus, the marked deceleration evident in inflation during 2003 is expected to continue next year.

### ***Modest Bond Issuance Next Year***

The authorities raised some €6bn net through the issuance of Irish government bonds in both 2002 and 2003. They will have a smaller funding schedule in 2004. Some €0.6bn of long term debt will mature in 2004. On top of this, the Dept of Finance is projecting an Exchequer Borrowing Requirement of €2.8bn next year. Taken together, it implies that the authorities will have a total funding requirement of just under €3.5bn in 2004.

With four large benchmark stocks already in existence, funding in 2004 may be concentrated in a new bond, possibly at the long end of the curve. There has been some speculation that there may be a new fifteen year issue which should meet with strong demand from investors, given the lack of paper in this part of the eurozone curve.

2004 GDP FORECASTS (%)			
	AIB	D/Finance	ESRI
Private Consumption	3.5	3.6	3.2
Government Expd.	2.5	2.1	1.4
Fixed Investment	2.5	1.3	1.2
Exports	4.5	3.9	2.6
Imports	3.5	3.6	1.1
GDP	4.0	3.3	3.2
GNP	3.7	3.0	3.1

2004 FUNDING REQUIREMENT (€m)*	
<b>Redemptions</b>	
(i) Irish Government Bonds	215
(ii) Foreign Debt	379
(iii) Total Redemptions [(i) + (ii)]	594
(iv) Exchequer Borrowing Requirement	2,806
(v) Total Funding Requirement [(iii) +(iv)]	3,400
* Assumes zero net funding via Small Savings and Short Term Paper	

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